

7535-01-U

NATIONAL CREDIT UNION ADMINISTRATION

12 CFR Part 703

RIN 3133-AD27

Permissible Investments for Federal Credit Unions

AGENCY: National Credit Union Administration (NCUA).

ACTION: Final rule.

SUMMARY: NCUA is amending its investments rule to allow federal credit unions (FCUs) to enter into investment repurchase transactions in which the instrument consists of first-lien mortgage notes subject to certain limitations. The final rule expands FCU authority to invest in mortgage-related securities while addressing safety and soundness concerns associated with this new investment activity.

DATES: This rule is effective for January 19, 2007.

FOR FURTHER INFORMATION CONTACT: Technical Information: Jeremy Taylor, Senior Investments Officer, Office of Capital Markets and Planning, at National Credit Union Administration, 1775 Duke Street, Alexandria, Virginia 22314, or telephone: (703) 518-6620. Legal Information: Moissette Green, Staff Attorney, Office of General Counsel, at the above address or telephone: (703) 518-6540.

SUPPLEMENTARY INFORMATION:

A. Background

In July 2006, NCUA proposed to amend its investment rules in Part 703 to permit FCUs to engage in investment repurchase transactions in which the underlying instruments are mortgage notes evidenced by participation or trust receipts. 71 FR 42326 (July 26, 2006). The preamble to the proposed rule discussed the statutory authority, its legislative history, and NCUA regulatory implementation regarding FCU investment in mortgage-backed and mortgage-related securities. The Federal Credit Union Act (Act) permits FCUs to invest in securities offered and sold pursuant to section 4(5) of the Securities Act of 1933. 12 U.S.C. 1757(15)(A); 15 U.S.C. 77d(5). The Board had limited this authority by regulation under the eligible obligations rule so that FCUs could only purchase the mortgage notes of its members or those needed to complete a pool of loans to be sold on the secondary market. 12 CFR 701.23. The proposal to amend

§703.14 to permit mortgage note repurchase transactions contained six conditions to address safety and soundness concerns including a credit concentration limit, minimum credit rating, independent assessment of market value, maximum transaction term, custodial requirements, and undivided interests in mortgage notes. NCUA issued the proposed rule with a 60-day comment period and requested comments on the plan to expand FCU investment authority, the conditions in the proposed rule, and whether a regulation permitting mortgage note repurchase transactions should contain additional criteria.

B. Public comments and the final rule

NCUA received comments from three credit unions, three trade associations, and one investment advisor on the proposed rule. Two commenters agreed with the use of independent, qualified agents to assess the market value of the mortgage notes and the requirements for undivided interests in the mortgage notes. Five commenters believed tri-party custodial arrangements would sufficiently identify the underlying loans in a mortgage note repurchase transaction. Four commenters stated the rule needed no additional underwriting criteria because the definition of the permissible securities in §107(15)(A) includes the required criteria. Relying on reasons similar to those in the comments regarding underwriting criteria, five commenters contended the rule should not address the quality of the mortgage notes in repurchase transactions. All the commenters

objected to the concentration limits, credit rating requirements, and maximum transaction term. The NCUA Board has considered carefully the three objections to the proposed rule.

Concentration limits

The proposed rule contained concentration limits of no more than 25% of a participating FCU's net worth with any one counterparty and 100% of its net worth with all counterparties. Commenters stated the proposed concentration limits are too restrictive. One commenter suggested the limits should be 50% of net worth per counterparty and a total limit similar to the FCU borrowing limit in §107(9) of the Act, i.e., 50% of paid-in and unimpaired capital and surplus. See 12 U.S.C. 1757(9). Two others stated the existing requirements for investment repurchase transactions in Part 703 are sufficient and no additional limits are necessary for mortgage note repurchase transactions, unless an FCU's directors establishes them.

NCUA investment rules currently require directors to develop investment policies that outline how FCUs will manage credit risk, including what counterparties an FCU will use, criteria for their selection, and the limits for investments with each counterparty. 12 CFR 703.3. Additionally, §703.13(c) permits FCUs to enter into investment repurchase transactions so long as the underlying securities are permissible investments, and the investing FCU takes possession or is the

recorded owner of the security, receives a daily assessment of the securities' market value, maintains adequate margins that reflect the risk and term of the transaction, and enters into signed contracts with the approved counterparties. The Board recognizes there is no concentration limit for investment repurchase agreements under §703.13(c). These repurchase transactions involve permissible investments that are of high credit quality, for example, U.S. government securities, investment grade rated municipals, AA and AAA mortgage related securities, and securities issued or guaranteed by GSEs. In contrast, mortgage note repurchase agreements involve unrated mortgage notes.

Additionally, the securities involved in §701.13(c) investment repurchase transactions typically have an active bid-ask market. Mortgage notes do not have an active bid-ask market, although the fair value of the mortgage notes may be estimated with reasonable accuracy. Thus, while the Board is comfortable that credit unions can set prudential margin requirements, mortgage notes may have less liquidity than other securities involved in repurchase transactions. Moreover, the Board notes the Office of the Comptroller of the Currency limits mortgage notes to no more than 25% of capital. See 12 U.S.C. 84(a)(2), (c)(4); 12 CFR 32.2(k)(91)(iii), (n); 12 CFR 32.3.

Thus, the Board having fully considered the comments on this issue has determined to maintain the concentration limits as proposed because it believes a 25% concentration limit per counterparty is no more restrictive than the limit for

national banks and maintains this and the 100% limit for purposes of safety and soundness.

Credit rating requirement

Commenters also objected to the proposed requirement that the counterparty to a mortgage note repurchase agreement have a long-term credit rating no lower than A- (or its equivalent). While mortgage note repurchase transactions generally have a short term, parties may rollover the transactions and enter into subsequent transactions, thereby creating a longer term of exposure to the counterparty. It is prudent to review the long-term rating of debt issued by the counterparty when rolling over repurchase transactions. Economically, the credit exposure in a mortgage note repurchase transaction may be somewhat similar to an investment grade asset-backed security (ABS) if debt of the issuing entity has been rated investment grade or if the mortgage note is guaranteed by an entity with investment grade debt. There is a distinction, however, in that an investment grade ABS is in and of itself highly rated, and the participant is relying on a credit rating of debt that is not applicable to the mortgage note as an indicator of the likelihood of default of the counterparty. Thus, the Board reasons that single A- (the third highest of the four long-term investment grades), rather than BBB- (the lowest category of investment grade), is a prudent and appropriate safety and soundness standard.

While the final rule retains the requirement for long- and short-term credit ratings as in the proposed rule, the final rule modifies the requirement by allowing a third party, that has the required credit rating, to fully guarantee the mortgage note repurchase transaction of a counterparty that does not meet the requirement. This modification reflects market practice in which a parent company guarantees mortgage note repurchase transactions of its subsidiary. Accordingly, the final rule requires a counterparty to have acceptably rated debt or that a party with acceptably rated debt guarantee the transaction.

Maximum transaction term

Finally, commenters contended that the maximum term of a mortgage note repurchase transaction should be longer than, as proposed, 30 days.

Commenters pointed out investors in the current market have kept repurchase agreements short due to the uncertain interest rate environment and abnormal yield curve. Commenters stated the market to finance whole loans traditionally mirrors the overall holding period of 45 to 90 days for securitization. Additionally, commenters believe the concentration limits and credit quality of the counterparty are sufficient safeguards given the aggregate size of mortgage note repurchase transactions. The Board is persuaded that a 90-day transaction is consistent with market practice and creates no additional safety and soundness risks.

Therefore, the maximum transaction term in the final rule is modified to 90 days.

While this final rule amends §703.14 to create additional requirements for investment repurchase transactions when mortgage notes are the underlying instruments, FCUs must still comply with the requirements of §703.13(c). For instance, an FCU must obtain the daily assessment required under §703.13(c)(1). In addition, FCUs investing in mortgage note repurchase transactions must maintain adequate margins that reflect a risk assessment of the mortgage notes and the term of the transactions under §703.13(c)(1).

C. Regulatory Procedures

Regulatory Flexibility Act

The Regulatory Flexibility Act requires NCUA to prepare an analysis to describe any significant economic impact a rule may have on a substantial number of small entities, those credit unions with less than ten million dollars in assets. The proposed rule involves the permissibility of certain investment repurchase transactions for FCUs and is grounded in NCUA concerns about the safety and soundness of the transactions and their potential effects on FCUs and the NCUSIF. Accordingly, the Board determines and certifies that this proposed rule does not have a significant economic impact on a substantial number of small credit unions and that a Regulatory Flexibility Analysis is not required.

Paperwork Reduction Act

NCUA has determined that this rule will not increase paperwork requirements

under the Paperwork Reduction Act of 1995 and regulations of the Office of Management and Budget.

Executive Order 13132

Executive Order 13132 encourages independent regulatory agencies to consider the impact of their actions on state and local interests. In adherence to fundamental federalism principles, NCUA, an independent regulatory agency as defined in 44 U.S.C. 3502(5), voluntarily complies with the executive order. This rule will not have substantial direct effects on the states, on the relationship between the national government and the states, or on the distribution of power and responsibilities among the various levels of government. NCUA has determined that this rule does not constitute a policy that has federalism implications for purposes of the executive order.

The Treasury and General Government Appropriations Act, 1999--Assessment of Federal Regulations and Policies on Families

The NCUA has determined that this rule will not affect family well-being within the meaning of the Treasury and General Government Appropriations Act, 1999, Pub. L. 105-277, 112 Stat. 2681 (1998).

Small Business Regulatory Enforcement Fairness Act

The Small Business Regulatory Enforcement Fairness Act of 1996, Pub. L. 104-121 (SBREFA), provides generally for congressional review of agency rules. A

reporting requirement is triggered in instances where NCUA issues a final rule as defined by section 551 of the APA. 5 U.S.C. 551. NCUA has requested a SBREFA determination from the Office of Management and Budget, which is pending. As required by SBREFA, NCUA will file the appropriate reports with Congress and the General Accounting Office so that the final rule may be reviewed.

List of Subjects in 12 CFR part 703

Credit unions, Investments, Repurchase transactions.

By the National Credit Union Administration Board on December 14, 2006.

/s/

Mary F. Rupp

Secretary of the Board

For the reasons set forth in the preamble, the Board amends 12 CFR part 703 as set forth below:

PART 703—INVESTMENT AND DEPOSIT ACTIVITIES

1. The authority citation for part 703 is continues to read:

Authority: 12 U.S.C. 1757(7), 1757(8), 1757(15).

2. Amend §703.1 by revising paragraph (b)(2) to read as follows:

§703.1 Purpose and scope.

* * * * *

(b) * * *

(2) The purchase of real estate-secured loans pursuant to Section 107(15)(A) of the Act, which is governed by §701.23 of this chapter, except those real estate-secured loans purchased as a part of an investment repurchase transaction, which is governed by §§703.13 and 703.14 of this chapter;

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3. Amend §703.2 by inserting the definition of “independent qualified agent” alphabetically between the definitions of “immediate family member” and “industry-recognized information provider” to read as follows:

§703.2 Definitions.

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Independent qualified agent means an agent independent of an investment repurchase counterparty that does not receive a transaction fee from the

counterparty and has at least two years experience assessing the value of mortgage loans.

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4. Amend §703.14 by inserting new paragraph (h) to read as follows:

§703.14 Permissible investments.

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(h) Mortgage note repurchase transactions. A federal credit union may invest in securities that are offered and sold pursuant to section 4(5) of the Securities Act of 1933, 15 U.S.C. 77d(5), only as a part of an investment repurchase agreement under §703.13(c), subject to the following conditions:

- (1) The aggregate of the investments with any one counterparty is limited to 25 percent of the credit union's net worth and 100 percent of its net worth with all counterparties;
- (2) At the time a federal credit union purchases the securities, the counterparty, or a party fully guaranteeing the transaction, must have outstanding debt with a long-term rating no lower than A- or its equivalent and outstanding debt with a short-term rating, if any, no lower than A-1 or its equivalent;
- (3) The federal credit union must obtain a daily assessment of the market value of the securities under §703.13(c)(1) using an independent qualified agent;
- (4) The mortgage note repurchase transaction is limited to a maximum term of 90 days;

(5) All mortgage note repurchase transactions will be conducted under tri-party custodial agreements; and

(6) A federal credit union must obtain an undivided interest in the securities.